

## Accounting Information System and Financial Reporting Quality: Role of Internal Audit Effectiveness

Amir Fayyaz<sup>1</sup>, Muhammad Ishtiaq<sup>\*2</sup>, Faisal Anees<sup>3</sup>

<sup>1</sup>MS (Business Administration) Scholar, Lyallpur Business School, Government College University, Faisalabad, Punjab, Pakistan.

<sup>2\*</sup> Associate Professor, Lyallpur Business School, Government College University, Faisalabad, Punjab, Pakistan.

<sup>3</sup> Assistant Professor, Lyallpur Business School, Government College University, Faisalabad, Punjab, Pakistan.

Corresponding author: [mishtiaq@gcuf.edu.pk](mailto:mishtiaq@gcuf.edu.pk)

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*The Financial Reporting Quality (FRQ) has a great impact on the effective decision-making and business success due to enhance credibility. Hence, the main focus of this study is to judge the mediating role of Internal Audit Effectiveness (IAE) between Accounting Information System (AIS) and FRQ. Primary data has been taken through questionnaire under self-delivery and collection method. Based on a sample of 250 audit managers in Pakistani Textile Sector, the results indicate that the AIS helps to enhance IAQ and FRQ. The findings of current study are useful for academics, government and companies of textile sectors that prioritize transparency and accuracy in their financial reporting tend to be more successful in the long term, with better access to capital and stronger stakeholder relationships.*

## 1. Introduction

Pakistan is one of the leading textile and garments exporters in South Asia. The country's economic growth has been significantly boosted by this industry, which accounts for 60.82% in total exports in FY2022. According to the Official Annual Analytical Report on External Trade Statistics of Pakistan FY 2021-22, the proportion of the textile sector to total exports has been climbed by 25.5% during FY2022 in comparison to a growth of 22.9% of previous year. This high growth in textile sector provides both opportunities as well as threats for management. Such rapid growth often strains existing systems and available resources. It may complex the daily operations and decision-making process. The revelation in information technology in the last two decades has brought a dynamic change in the operational productivity and efficiency of the businesses.

Now, companies rely on different information systems to manage their various resources such as Financial, Physical, Human and Material. Similarly, a company needs to be efficient in its AIS to support accounting functions and business decision-making more effectively. The AIS is a powerful force that supports executive in making fair and appropriate decision. Furthermore, it provides fast, reliable and accurate information to all interested parties (Abbott et al., 2016). Competitors can sometime spread asymmetric knowledge in the market, and this is due to poor governance (Kuzey & Uyar, 2017).

On the other hand, the purpose of AIS is to convey authentic financial information of the company to different stakeholders (Sari et al., 2019). AIS analyses large amounts of data, converts it into actionable information, and distributes it to managers and executives (Al-Dmour, 2018). Information of top quality provides a competitive advantage (Al-Okaily et al., 2020). Managers can use the data to assess progress and spot flaws (Soudani, 2012). In order to assess the financial risk of processes, managers must implement an internal control, which is one of the AIS tools. Internal control evaluates and oversees the effectiveness of accounting procedures for business performance (Sajady, Dastgir & Nejad, 2012). An effective internal audit is the product of efficient AIS and, due to the strong accounting information system, produces good financial reporting quality (Savčuk, 2007).

External parties benefit from a high level of financial reporting quality. The high level of FRQ is created by the accounting information system. The importers are affected by the high quality of financial reporting and give bulky orders to the textile sector and, due to the bulky orders of export, dollars will start coming to Pakistan due to which Pakistan will develop very quickly. That is why this topic is helpful for the development of the textile sector in Pakistan.

According to Al-Dmour, (2018), there is a positive relationship between internal controls and accounting data systems that contributes to the reliability of financial reporting. Internal control defects in the management of the AIS might raise the possibility of materially incorrect data reporting, as suggested by the research. Accounting systems that provide reliable financial statements need to be managed using internal controls. Internal control and AIS play a crucial role in producing high-quality financial reports that can serve as a basis for leadership and other stakeholders' choice. Furthermore, Samagaio & Felício (2023) concurred that although if audits are conducted by skilled employees utilizing a variety of approaches

and in accordance with generally recognized best practices, they should not be taken for granted. Consequently, the choice of internal auditors is crucial in deciding how efficient the internal audit function is (Thiéry, Lhuillery & Tellechea, 2023). As a result, any firm should take into account the choice of such auditors since it also affects the efficiency of internal audits.

Understanding the factors that determine IAE is crucial, although it can achieve four critical organizational processes learning (training staff on how to perform their jobs more effectively), inspiration (auditing also improves success), protection (noticing that an audit will prevent any actions that could result in harm), and improved efficiency (ensuring that the correct things are done).

The aim of the study is to examine the mediating role of IAE in relationship between AIS and FRQ. For this purpose, the particular study has following objectives:

- To examine the impact of AIS on IAE.
- To recognize the effect of IAE on relational FRQ.
- To examine the impact of AIS on FRQ.
- To judge the mediating role of IAE in relationship between AIS and FRQ.

As discussed earlier, AIS is essential for enhancing the FRQ. This study improves the literature by considering the fact that FRQ is profound, as it directly impacts decision-making, economic stability, corporate governance, and overall market efficiency. The current research intends to explore how accurately, transparently, and consistently a company's financial information is disclosed to stakeholders. Understanding and analyzing FRQ is essential for various stakeholders, including investors, regulators, management, and auditors.

## **2. Literature Review**

AIS is an accounting technique that assists administration in the planning, supervision, and monitoring of an organization's economic activities. AIS help prepare with significant information to help them make decisions (Fitrios, 2016). AIS is critical for regulating a company and implementing an internal control. Accounting irregularities and financial statement misuse have shown inefficiencies in internal monitoring. AIS is accept as an effective method of coping with changes in the internal by examining data and operations to provide important information for business activity planning, controller, and movement, as well as boosting and achieving organizational effectiveness (Al-Okaily et al., 2020). The success of AIS may be measured along three dimensions informational scope, collection, and accuracy (Neogy, 2014). Financial and non-financial data, as well as internally and externally collected information, play a vital part in future occurrences, to the extent of the information. Although important, informational collections highlight the collection and summarization of data over time (Petratos & Faccia, 2019)..

The term "financial reporting quality" has varying meanings. Like a large topic area, financial reporting quality, various definitions can be studied from various users' viewpoints. Yusran (2023) has provided the first such definition, defining it as the accuracy with which financial reports convey information about the firm's operations, especially its cash flows, to advice stockholders. According to Herath & Albarqi (2017) expressing the financial

performance and the firm condition as FRQ is the level of fulfilling the true and fair perspective of the financial statements. The primary goal of FRQ is to provide decision-making tools that are practical, sufficient, and accurate for financial reporting users. According to Kumar (2014), it is challenging to define FRQ due to the complicated atmosphere that encompasses a wide range of topic disciplines, including surroundings, laws, processes, and explanations. In accordance with Renkas, Goncharenko & Lukianets (2015) there are two major categories of quality characteristics fundamental and enhancing. When examining the impact of incorporating unhelpful or deceptive information into an accurate presentation of information, the fundamental information on financial reporting defines usefulness and relevancy. When the information from the financial reports gives the decision-makers a different way to go, that is when the information is relevant. Enhancing qualities are increases the impact of fundamental characteristics in determining financial reporting quality. As a result, only fundamental features can boost the decision utility of financial reporting; enhancing qualities cannot. In comparison, accuracy, comprehensibility, and reliability are specifically improving qualities.

When it comes to internal assurance for government and regulatory bodies, internal auditing plays a special role. Internal auditors who are successful in their roles will have the following traits does still transmissions ability (stability in technique, guidelines, and transmitting), including the ability to keep audit focused and incorporate investments with the strategic plan; remedies skills that will ensure the permanent audit teams equal exposure; the capacity to accord the institutional audit framework with the dynamics of the firm activities; a direct connection involving management talents for maintaining (Al-Twajjry, Brierley & Gwilliam, 2003).

Organizational independence; authority (authorized audit charter present), unrestricted access, adequate funds, sound managerial staff, qualified employees, presence of an internal auditors, stakeholder reinforcement, qualified audit criteria, and unrestrained scope may all contribute to effective internal auditing, which in turn may be useful for boosting public trust in the financial reporting and financial reporting (Sarens, 2009).

## **2.1 Theory of Inspired Confidence**

The demand for audit services is directly impacted by the engagement of third parties (interested parties of a corporation) in the firm. Because the internal audit effect good AIS and generate high quality of financial reporting. In exchange for their financial commitment to the textile sector, these shareholders demand accountability from the management (monetary commentary excellence). FRQ that are released on a regular basis serve as proof of good accounting information system. However, an audit is needed to ensure the accuracy of this AIS because the management may present biased information and outside parties lack effective supervision capabilities. According to Limperg (1932), the audit shall constantly work effectively to fulfill the shareholders expectations when it comes to the provision of audit assurance.

In the light of literature there was gap in the field of Accounting information system, internal audit effectiveness as well as financial reporting system. First of all there was not any in depth study about the relationship between AIS and FRQ where mediating role of IAE. The

available literature has witnessed limited focus on the relationship of this constructs. Another gap of literature which this study considered as opportunity is there was not any empirical study Pakistani context about this relationship. So, particular observation aims to target Pakistani textiles as the chosen respondents for this study. Additional gap which cannot be avoided is the only qualitative study has done in familiar frameworks. Our study struggled to get primary data and provide evidence in support of study hypotheses.

## **2.2 AIS (Accounting Information system) and IAE (Internal Audit Effectiveness)**

The incorporation of internal audit (IA) procedures into an organization's AIS helps to guard resources against theft, as well as maintain reliable financial records (Almaliki et al., 2019). Accounting is widely seen as a reliable source of information for making decisions, particularly managerial decisions. It has been discovered by several researches (Fitrios, 2016; Al-Okaily et al., 2020) that high-quality information offered by AIS aids all levels of organization in making sound choices that bring the firm closer to its objectives.

Hla & Teru (2015) have stated that AIS are accountable for documenting, analyzing, monitoring, and assessing the monetary status of businesses. In addition, it helps improve control and governance by providing more information and allowing for more accurate risk evaluation. A company internal audit performance may be greatly boosted by the wise choices of its management, which can be facilitated by the accountant staff and leadership expertise. If an organization accountants and auditors have a lot of expertise, they should be able to outperform competitors that don't have as much (Newman & Comfort, 2018). According to Arena & Azzone (2009), IA is a core function of the business and IAE is integrally linked to the success of IA initiatives. The Internal Auditing Effectiveness (IAE) is defined as how well an internal audit department achieves its stated goal or achieves its studied consequence (Shamki & Alhajri, 2017).

According to Almaliki et al. (2019), the value of AIS for improving internal audit effectiveness lies in its ability to provide reliable, structured, and comprehensive data management solutions. Rapani & Malim (2018) have also suggested that AIS supports internal audit activities through its integration of technology, processes, and controls, enhancing the quality and efficiency of audit operations. Furthermore, the utility of an AIS lies in its ability to streamline processes, improve data accuracy, and provide insights that empower auditors to perform more effective, efficient, and risk-focused audits. By leveraging AIS capabilities, organizations can significantly enhance the effectiveness of their internal audit functions. Thus, the initial assumption is:

***H1: AIS has significant impact on IAE***

## **2.3 IAE (Internal Audit Effectiveness) and FRQ (Financial Reporting Quality)**

Abbott et al. (2016) has suggested that the purpose of a compliance audit is to ensure that the company financial reporting policy has been followed. Similarly, IAE plays a pivotal role in enhancing FRQ by ensuring accuracy, transparency, and compliance (Abbott et al., 2016). The effectiveness of internal audits is directly tied to improvements in financial reporting quality (Gebrayel et al., 2018). By fostering accuracy, transparency, compliance, and risk management, internal audits ensure that financial reports are reliable, timely, and

meet the needs of stakeholders (Kaawaase et al., 2021). This alignment not only strengthens organizational governance but also builds confidence among investors, regulators, and the public. Therefore, the following hypothesis is formulated in the current study based on the expectation that an efficient internal audit function will affect the quality of financial reporting.

***H2: IAE has significant impact on FRQ***

**2.4 AIS (Accounting Information system) and FRQ (Financial Reporting Quality)**

AIS is a group of people and machines working together to transform financial and other kinds of data into information. The next step is for decision-makers to talk about the numbers. Fuadah & Setiyawati (2020) have suggested that if an organization has a high-quality AIS, then the FRQ it generates will be of a high standard as well. Similarly, Al-Dmour (2018) has highlighted that the improvements in accounting information system lead to gains in business performance. This is consistent with the results of Abdallah (2013) who has studied the implications of the AIS on the quality of financial statements in Jordan. On the other hand, insignificant results have been found regarding the relationship between AIS and FRQ considering some other important factors such as Corporate Governance Quality, Internal Control System, Human Resource Competency and etc. as well (Sagara, 2015; Majid, Suwandi & Bulutoding, 2020; Sumaryati, Praptika Novitasri & Machmuddah, 2020; Hasan, Aly & Hussainey, 2022).

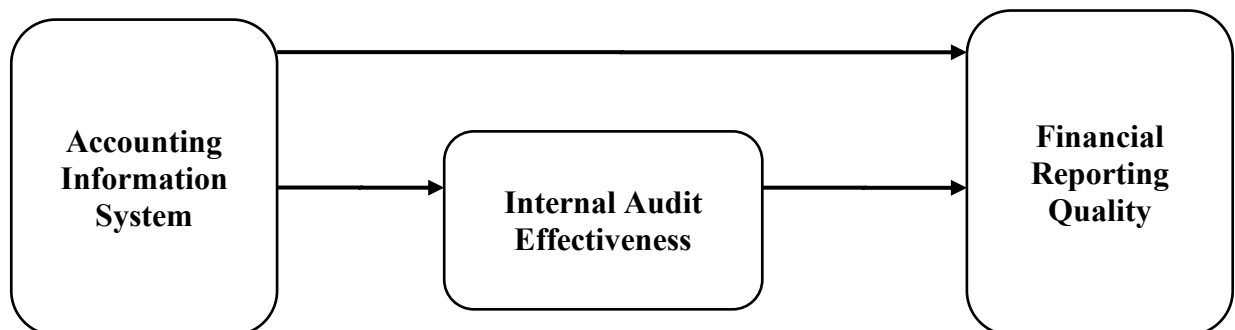
***H3: AIS has significant impact on FRQ.***

**2.5 IAE as mediator between AIS and FRQ**

As there are many arguments has been presented in the previous section in order to clarify the relationship between all proposed construct. IAE may have a significant role in mediating relationship between AIS and IAE (Majid, Suwandi & Bulutoding, 2020). So the forth hypothesis of the study is

***H4: IAE mediates the relationship between AIS and in FRQ.***

**Figure No 1: Conceptual Framework**





### 3. Research Methodology

Managers that engage in the textile sector as audit managers (audit department) are considered responders in this research. For the goal of gathering primary data, each textile organization was visited directly to contact the respondents, who were then given the study questionnaire by hand. Total 250 questionnaires were distributed to various textile sectors. Considering the nature of the study, Self-delivery and collection methods has been adopted (Bryman & Bell, 2011). The questionnaire items have been adopted from previous studies (Alzeban & Gwilliam, 2014; Al-Dmour, 2018; Fuadah & Setiyawati, 2020). Furthermore, stratified random sampling technique has been applied. From each selected textile firm, one or two managers have been randomly chosen to obtain their responses.

### 4. Results and Discussion

Table 1 reports different demographical characteristics of the respondents such as their gender, age and work experience.

**Table No 1: Demographic Information**

Demographics	Respondents	Percentage	Cumulative Percentage
<b>Gender</b>			
Male	187	93.5	93.5
Female	13	6.5	100.0
<b>Age</b>			
20-25	6	3.0	3.0
25-35	25	12.5	15.5
35-45	50	25.0	40.5
45-55	76	38.0	78.5
55 and Above	43	21.5	100.0
<b>Education</b>			
Graduation	17	8.5	8.5
Postgraduation	34	17.0	5.5
CA/ACCA	48	24.0	49.5
Diploma	67	33.5	83.0
Others	34	17.0	100
<b>Working Experience</b>			
Up to 5 Years	19	9.5	9.5
6-10 Years	40	20.0	29.5
11-15	55	27.5	57.0
16-20	51	25.5	82.5
21 or More	35	17.5	100.0

#### 4.1 Accounting Information System

The current study has adopted six items to measure AIS. A short summary is presented in Table 2.

**Table No 2: Respondents' response on Accounting Information System**

<b>Accounting Information System</b>		
<b>Items</b>	<b>Mean</b>	<b>SD</b>
1. The accounting information system helps to the credibility of the process of financial reporting.	3.2950	1.07412
2. The accounting information is sufficiently detailed to depict the company accurately and honestly.	3.2950	1.05525
3. From the standpoint of the firm's management, accounting information is of tremendous importance for level enhancement.	3.4850	1.19453
4. AIS provides the user an effective financial report with more quality	3.2000	1.17341
5. Implementing an accounting information could save shareholders time and money.	3.3400	1.10476
6. The accounting information improved the level of the financial statements and streamlined the company's transactional processes.	3.5300	1.11143
N = 200		

All item means fall somewhere between 3.2 and 3.5 medians. The highest mean (3.5300) is seen in question six, where respondents are asked to rate how they think accounting data helped boost financial report quality and streamline business operations. There exists a shared understanding of accounting data systems throughout the management staffs of textile companies. As such, it may serve as a useful indicator of how successfully the chosen textile companies will be able to manage the quality of their financial reporting in the future. The first item, in which respondents aid in maintaining the honesty of the accounting information system financial reports, has the lowest mean (3.2950). This seems to suggest that certain textile companies' accounting information systems aren't as well understood as they should be.

#### 4.2 Internal Audit Effectiveness

**Table No 3: Respondents' response on Internal Audit Effectiveness**

<b>Internal Audit Effectiveness</b>		
<b>Items</b>	<b>Mean</b>	<b>SD</b>
Internal audit ensure that it adds value to the business.	3.8650	1.10129
A well-executed internal audit may do wonders for a company's bottom line.	3.5700	1.09595
There is backing for the internal audit team from the upper echelons of management.	3.7550	1.02481
It is possible to accomplish goals related to avoiding fraud risks with the data included in the audit report.	3.7500	1.00626
IAE provides more clarity which enhance the quality of FR	3.7300	1.04044
If the internal auditing department finds a flaw in the system of internal control, they will let you and the board know about it.	3.5400	1.10658
Internal audit recommends solutions to the problems.	3.5550	1.06425
Internal audit is the achievement of the auditor's objectives and finds no problems.	3.5500	1.07390
N = 200		



In order to measure internal audit effectiveness, it has been asked eight times. The average and standard deviation are displayed in Table 3 for the collected responses (SD). All of the numbers in Table 3 demonstrate that there is relatively little variation across textile managers' replies. Nevertheless, the average response to each topic fluctuates between 3.55 and 3.86. The first item of audit committee characteristics has the composite average (3.8650), in which participants were asked for their opinions on whether internal audit brings value to the firm. The high mean indicates that the evaluated textile companies have implemented internal auditing. In contrast, the mean for the eighth item is the lowest (3.5500) indicating that the selected manufacturing industry has difficulty prioritizing their important internal audit performance.

### 4.3 Financial Reporting Quality

Seven items about the financial reporting quality has been included to measure FRQ. Table 4 shows the results of these items.

**Table No 0: Respondents' response on financial reporting quality.**

Financial Reporting Quality		
Items	Mean	SD
Financial reporting quality provides knowledge about future operations.	3.3100	1.23756
Financial reporting quality provides for comprehensive and transparent presentation	3.2800	1.16980
Financial reporting quality reflects the company business activities.	3.6000	1.16481
Financial reporting quality can be improve by effective internal audit	3.4650	1.03155
Financial reporting is based on measure with little uncertainty and few assumption.	3.6400	1.03234
Financial reporting quality is neutral when good AIS been adopted.	3.5650	1.13677
Financial reporting explains the choice of accounting principles clearly in annual report	3.6250	1.04875
N = 200		

There is little distinction between the audit managers' comments in Table 4. The mean response for each item ranges between 3.28 and 3.64. The average value for the fifth element of quality of financial reporting is the greatest (3.6400) and reveals that the FRQ provides for comprehensive and transparent presentation. The second item show the lowest average value (3.2800) and reveal that the firm have lack of information about FRQ provides for comprehensive and transparent presentation.

### 4.4 Relationship between AIS and IAE

Considering the reported figures mentioned in Table 5, it can be concluded that the AIS has significant impact on AIS. Hence, H1 has been supported that AIS has significant impact on IAE.

**Table No 5: Regression test H1**

Test	Values
Correlation	0.417
R square	0.174
Adjusted R	0.170
F value	41.74
Coefficient Beta	0.417
Significance Value	0.000

a. Dependent Variable meanIAE

b. Predictors (Constant), meanAIS

Based on the above-mentioned results, it can be concluded that an AIS has a key role in the improvement IAE. Therefore, reliable, accurate and efficient Accounting Information Systems in the Pakistani Textile Industry are vital to improve the usefulness of internal audits practices. Therefore, the top management should formulate effective policy making in this regard.

#### 4.5 Relationship between IAE and FRQ

Table 6 shows that one-unit change in IAE may cause .439 unit change in the FRQ. Therefore, H2 has been proved that AIE has significant impact on FRQ.

**Table No 6: Regression test for H2**

Tests	Values
Correlation	0.439
R square	0.192
Adjusted R	0.188
F value	47.19
Coefficient Beta	0.439
Significance Value	0.000

a. Dependent Variable meanFRQ

b. Predictors (Constant), meanIAE

Considering the above-mentioned results, it can be concluded that the effectiveness of internal audit has a significant role on the financial reporting quality in the selected companies. Therefore, IAE is very useful within an organization not only for the improvement of improved FRQ but also may enhance the reliability of the financial statements for different stakeholders such as existing shareholders regulators, future investors and governments.

#### 4.6 Relationship between AIS and FRQ

Table 7 indicates that one-unit change in AIS brings 0.587unit changes in FRQ. Hence, H3 has been proved that AIS has significant impact on FRQ. Therefore, it may be concluded that the AIS has a significant impact in enhancing FRQ in the textile sector of Pakistan. The effectiveness and improvement in AIS further bring positive change in the FRQ. Therefore, it is important for the management in textile firms to give more focus on the improvement of the AIS to ensure accuracy, transparency and consistency in the financial statements.

**Table No 7: Regression test for hypothesis three**

Tests	Values
Correlation	0.584
R square	0.341
Adjusted R	0.338
F value	102.47
Coefficient Beta	0.587
Significance Value	0.000

#### 4.7 IAE mediates the relationship between AIS and FRQ

Table 8 illustrates important results to show the mediating role of IAE between the relationship of AIS and FRQ. All the paths between AIS, IAE and FRQ are statistically significant. Based on the results reported in Table 8, the fourth hypothesis (H4) of the study is accepted.

**Table No 8: Multiple regression test for hypothesis four**

Variables	Dependent Variable (FRQ)	
	Model 1	Model 2
<b>Independent Variable</b>		
AIS	0.417	0.584
<b>Mediating Variable</b>		
IAE		0.584
R Square	0.094	0.375
Adjusted R	0.091	0.371
F	30.896	89.032
R Square Change	0.094	0.281
F Change	30.896	130.437

Based on the above mentioned results, it may be concluded that the relationship between Accounting Information Systems (AIS) and Financial Reporting Quality (FRQ) is crucial for organizational success, and Internal Audit Effectiveness (IAE) can act as a mediator in this relationship.

#### 5. Conclusion

Whole study is focused on the constructs which has been proposed in the light of literature. AIS stands as the most important component of the best reporting quality. The relationship AIS and FRQ has been empirically and theoretically established as strong relationship in the current study. It shows that AIS playing a critical role in enhancing the accuracy, reliability, timeliness, and transparency of financial reports. Furthermore, the mediating role of Internal Audit Effectiveness (IAE) between Accounting Information

Systems (AIS) and Financial Reporting Quality (FRQ) has been empirically accepted. It further indicates that AIS enhances FRQ not just directly, but also indirectly by strengthening internal audit functions. Hence, a well-designed AIS provides accurate, real-time data and robust internal controls. It also empowers internal auditors to detect errors, prevent fraud and ensure compliance more efficiently. Consequently, it improves the reliability and transparency of financial reports. Thus, IAE acts as a crucial bridge for translating AIS capabilities into higher FRQ by ensuring that system-generated data is thoroughly verified, risks are mitigated, and governance standards are upheld before financial statements are finalized. This mediation underscores the importance of aligning AIS with strong internal audit practices to maximize reporting quality. Furthermore, it is concluded that the AIS plays an important role for the IAE as well as FRQ in the Pakistani Textile Sector. Efficient AIS ensures the alignments between Accounting and Auditing Functions within the organization and further helps to contribute significantly towards FRQ by providing more fast, accurate and reliable information. This may also help the audit team to be not only more efficient but also more truthful as well as insightful to protect the business unit from fraud, financial misstatements and operational inefficiencies. These factors are essential for building trust with investors, regulators, and other stakeholders, and for ensuring that financial statements meet the highest standards of quality.

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